

Letter of Findings: 04-20170019
Gross Retail Tax
For the Years 2013, 2014, and 2015

NOTICE: IC § 6-8.1-3-3.5 and IC § 4-22-7-7 require the publication of this document in the Indiana Register. This document provides the general public with information about the Department's official position concerning a specific set of facts and issues. This document is effective as of its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register. The "Holding" section of this document is provided for the convenience of the reader and is not part of the analysis contained in this Letter of Findings.

HOLDING

Company provided sufficient documentation to show that its protest items are exempt from Indiana gross retail tax because they are part of Taxpayer's manufacturing and fabricating process. Taxpayer also showed reasonable cause for the Department to abate the negligence penalty.

ISSUES

I. Gross Retail Tax - Direct Production.

Authority: IC § 6-2.5-2-1; IC § 6-2.5-3-1; IC § 6-2.5-8-8; IC § 6-2.5-5-3; IC § 6-2.5-5-4; IC § 6-8.1-5-1; *Indiana Dep't of Revenue v. Cave Stone Inc.*, 457 N.E.2d 520 (Ind. 1983); *Indiana Dept. of State Rev. v. Kimball Int'l Inc.*, 520 N.E.2d 454 (Ind. Ct. App. 1988); *North Central Industries, Inc. v. Indiana Dep't of State Revenue*, 790 N.E.2d 198 (Ind. Tax Ct. 2003); *Rhoads v. Ind. Dep't of State Revenue*, 774 N.E.2d 1044 (Ind. Tax Ct. 2002); *Tri-States Double Cola Bottling Co. v. Dep't of State Revenue*, 706 N.E.2d 282 (Ind. Tax Ct. 1999); *Mynsberge v. Dep't of State Revenue*, 716 N.E.2d 629 (Ind. Tax Ct. 1999); *Dept. of State Revenue v. Caterpillar, Inc.*, 15 N.E.3d 579 (Ind. 2014); *Indiana Dept. of State Revenue v. Rent-A-Center East, Inc.*, 963 N.E.2d 463 (Ind. 2012); *Lafayette Square Amoco, Inc. v. Indiana Dept. of State Revenue*, 867 N.E.2d 289 (Ind. Tax Ct. 2007); [45 IAC 2.2-5-8](#).

Taxpayer argues that the Department of Revenue erred when it determined that certain items of equipment were not directly involved in the direct production of Taxpayer's products.

II. Tax Administration - Penalty.

Authority: IC § 6-8.1-5-1(c); IC § 6-8.1-10-2.1; [45 IAC 15-11-2](#).

Taxpayer argues that the Department of Revenue should exercise its discretion to abate the ten-percent negligence penalty.

STATEMENT OF FACTS

Taxpayer is an Indiana business that manufactures metal products. Nearly all products are custom made for customers. The Department of Revenue ("Department") conducted an audit review of Taxpayer's business and tax records. The audit resulted in the assessment of additional sales and use tax. Taxpayer disagreed with a portion of the assessment. An administrative hearing was conducted during which Taxpayer's representatives explained the basis for its protest. This Letter of Findings results. Further facts will be supplied as required.

I. Gross Retail Tax - Direct Production.

DISCUSSION

During the course of the audit, the Department determined that a review of invoices showed that some "additional use tax is due on asset and expense purchases pursuant to [45 IAC 2.2-5-8](#)." Taxpayer maintains that its purchase of certain equipment was exempt because the equipment is used to manufacture its products. Specifically, Taxpayer argues that the following items are exempt from sales tax: rental equipment such as "scaffolds, cranes, aerial lifts, booms, etc." Taxpayer disagrees, stating that the protested items are used to assemble products at customers' sites. Because the product is so large it is impossible to create the entire product then transfer it safely to customer's locations. Taxpayer protests use tax assessed on rental equipment

and an invoice in which it subcontracted out half the work.

As a threshold issue, it is Taxpayer's responsibility to establish that the existing tax assessment is incorrect. As stated in IC § 6-8.1-5-1(c), "The notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." *Indiana Dept. of State Revenue v. Rent-A-Center East, Inc.*, 963 N.E.2d 463, 466 (Ind. 2012); *Lafayette Square Amoco, Inc. v. Indiana Dept. of State Revenue*, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007). Consequently, a taxpayer is required to provide documentation explaining and supporting his or her challenge that the Department's position is wrong. Further, "[W]hen [courts] examine a statute that an agency is 'charged with enforcing. . . [courts] defer to the agency's reasonable interpretation of [the] statute even over an equally reasonable interpretation by another party.'" *Dept. of State Revenue v. Caterpillar, Inc.*, 15 N.E.3d 579, 583 (Ind. 2014). Thus, all interpretations of Indiana tax law contained within this decision, as well as the preceding audit, shall be entitled to deference.

In applying any tax exemption, the general rule is that "tax exemptions are strictly construed in favor of taxation and against the exemption." *Indiana Dept. of State Rev. v. Kimball Int'l Inc.*, 520 N.E.2d 454, 456 (Ind. Ct. App. 1988). The exemption to which Taxpayer aspires, IC § 6-2.5-5-4, like all tax exemption provisions, is strictly construed against exemption from the tax. *Tri-States Double Cola Bottling Co. v. Dep't of State Revenue*, 706 N.E.2d 282, 283 (Ind. Tax Ct. 1999); *Mynsberge v. Dep't of State Revenue*, 716 N.E.2d 629, 636 (Ind. Tax Ct. 1999). Therefore, in order for Taxpayer to prevail on the different issues it raises, Taxpayer must demonstrate that the initial assessment was "wrong" and that it is instead entitled to a sales tax exemption which is "strictly construed" in favor of taxation.

Indiana imposes an excise tax called "the state gross retail tax" (or "sales tax") on retail transactions made in Indiana. IC § 6-2.5-2-1(a). A person who acquires property in a retail transaction (a "retail purchaser") is liable for the sales tax on the transaction. IC § 6-2.5-2-1(b). Indiana also imposes a complementary excise tax called "the use tax" on "the storage, use, or consumption of tangible personal property in Indiana if the property was acquired in a retail transaction, regardless of the location of that transaction or of the retail merchant making that transaction." IC § 6-2.5-3-2(a). Use means the "exercise of any right or power of ownership over tangible personal property." IC § 6-2.5-3-1(a). In effect and practice, the use tax is functionally equivalent to the sales tax. See *Rhoads v. Ind. Dep't of State Revenue*, 774 N.E.2d 1044, 1047 (Ind. Tax Ct. 2002).

A. Rental Property

Taxpayer protests the assessment of use tax on its rental of large equipment such as cranes, scaffolds, and other products provided in their protest. IC § 6-2.5-5-4 provides an exemption to tools used to build exempt machinery and equipment.

Transactions involving tangible personal property are exempt from the state gross retail tax if the person acquiring the property acquires it for his direct use in the direct production of the machinery, tools, or equipment described in section 2 or 3 of this chapter.

Purchases of tangible personal property by persons engaged in the direct production, manufacture, fabrication, assembly or finishing of tangible personal property are generally taxable. [45 IAC 2.2-5-8\(a\)](#). The purchase of tangible personal property such as cranes, scaffolding, etc. is exempt if the, tools, and equipment directly used by the purchaser in direct production. *Id.* Machinery, tools, and equipment are directly used in the production process if they have an immediate effect on the article being produced. [45 IAC 2.2-5-8\(c\)](#). A machine, tool, or equipment has an immediate effect on the product being produced if it is an essential and integral part of an integrated process that produces the product. [45 IAC 2.2-5-8\(c\)](#); *Indiana Dep't of Revenue v. Cave Stone Inc.*, 457 N.E.2d 520 (Ind. 1983). An integrated process is one where the total production process is comprised of activities or steps that are functionally interrelated and where there is a flow of "work-in-process." [45 IAC 2.2-5-8\(c\)\(1\)](#).

To summarize, machinery, tools, and equipment purchased for direct use in the production of manufactured goods are subject to use tax unless the property used has an immediate effect on the goods produced and is essential to the integrated process used to produce the marketable goods.

Proper application of the exemption requires determining at what point "manufacturing" begins and at what point "manufacturing" ends. [45 IAC 2.2-5-8\(d\)](#) states:

Pre-production and post-production activities. "Direct use in the production process" begins at the point of the first operation or activity constituting part of the integrated production process and ends at the point that the

production has altered the item to its completed form, including packaging, if required.

Under IC § 6-2.5-5-3(b):

Transactions involving manufacturing machinery, tools, and equipment are exempt from the state gross retail tax if the person acquiring that property acquires it for direct use in the direct production, manufacture, fabrication, assembly, extraction, mining, processing, refining, or finishing of other tangible personal property.

In addition, [45 IAC 2.2-5-8](#)(c) states:

The state gross retail tax does not apply to purchases of manufacturing machinery, tools, and equipment to be directly used by the purchaser in the production process provided that such machinery, tools, and equipment are directly used in the production process; i.e., they have an immediate effect on the article being produced. Property has an immediate effect on the article being produced if it is an essential and integral part of an integrated process which produces tangible personal property.

Finally, [45 IAC 2.2-5-8](#)(k) states:

"Direct production, manufacture, fabrication, assembly, or finishing of tangible personal property" is performance of a series of operations which places tangible personal property in a form, composition, or character different from that in which it was acquired. The change in form, composition, or character must be a substantial change, and it must result in a transformation of property into a different product having a distinctive name, character, and use. Operations such as compounding, fabricating, or assembling are illustrative of the types of operations which may qualify under this definition.

This manufacturing exemption test requires two steps: direct use and direct production of other tangible personal property. Taxpayer manufactures large structures per customer's requests. Most of the time Taxpayer is constructing part of the structure on its premise and then assembles and finishes the product at a customer's place of business. Taxpayer uses cranes and scaffolds that it rents to build and assemble the final product.

In this case, Taxpayer has provided an explanation for the purpose of the rental equipment. Taxpayer also provided pictures of the rental equipment being used and invoices showing how it is being charged for the equipment by vendor. Taxpayer explained that one of its customers ordered catwalks for an auto shredder system. Taxpayer made several components at its premise, but needed to assemble and weld the catwalk at customer's site. Taxpayer utilized cranes, aerial lifts and booms to complete the product.

Thus, pursuant to *Cavestone*, Taxpayer is engaging in production at customers' location. The product cannot be completed until Taxpayer moves the pieces to customers' location and assembles the final product there. Thus, Taxpayer's highlighted items on the provided work paper are exempt under IC § 6-2.5-5-4.

B. Exemption Certificate

The Department assessed use tax on a purchase invoice from an unrelated metal company. Taxpayer was hired by Customer to provide a product. Taxpayer could not complete the job on its own so it hired a separate metal company to assist with the product. Taxpayer paid metal company for the product. Taxpayer provided Customer's exemption certificate. Under IC § 6-2.5-8-8(a) a seller that accepts a proper exemption certificate has no duty to collect or remit sales tax. During the protest Taxpayer provided Customer's exemption certificate and a letter from Customer explaining the product it purchased.

Because the customer provided Taxpayer an exemption certificate, Taxpayer was not obligated to remit use tax on the invoice of the second metal company. Thus, Taxpayer's protest regarding the invoice from the second metal company is sustained. Taxpayer highlighted this item on the same list as described in section A.

FINDING

Taxpayer's protest is sustained for both the rental property and exemption product.

II. Tax Administration - Penalty.

DISCUSSION

Taxpayer protests the imposition of a ten percent negligence penalty. IC § 6-8.1-10-2.1(a)(3) requires that a ten-percent penalty be imposed if the tax deficiency results from the taxpayer's negligence.

IC § 6-8.1-10-2.1(d) states that, "If a person subject to the penalty imposed under this section can show that the failure to . . . pay the full amount of tax shown on the person's return . . . or pay the deficiency determined by the department was due to reasonable cause and not due to willful neglect, the department shall wave the penalty."

Departmental regulation [45 IAC 15-11-2](#)(b) defines negligence as "the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer." Negligence is to "be determined on a case-by-case basis according to the facts and circumstances of each taxpayer." *Id.*

IC § 6-8.1-10-2.1(d) allows the Department to waive the penalty upon a showing that the failure to pay the deficiency was based on "reasonable cause and not due to willful neglect." Departmental regulation [45 IAC 15-11-2](#)(c) requires that in order to establish "reasonable cause," the taxpayer must demonstrate that it "exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed"

Under IC § 6-8.1-5-1(c), "The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." An assessment - including the negligence penalty - is presumptively valid.

Taxpayer explained that it purchased the business from the previous owner during the time of the audit. It was not aware of the tax deficiencies at the time. Also Taxpayer has shown reasonable cause regarding tax assessed on the non-protested items, as required by IC § 6-8.1-10-2.1(d).

FINDING

Taxpayer's protest is sustained.

SUMMARY

As stated in issue I, Taxpayer's protest is sustained for the highlighted items it provided in its protest. As stated in Issue II, Taxpayer has shown reasonable cause to have penalty waived, thus Taxpayer's protest is sustained regarding negligence penalty.

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